U.S. PROXY VOTING POLICY STATEMENT & GUIDELINES

VERMONT STATE EMPLOYEES' RETIREMENT SYSTEM
Adopted February 19, 2004

VERMONT STATE TEACHERS' RETIREMENT SYSTEM
Adopted February 18, 2004

VERMONT MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM
Adopted February 20, 2004

OFFICE OF THE VERMONT STATE TREASURER
Adopted February 20, 2004

Effective March 1, 2004

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VERMONT RETIREMENT SYSTEMS
VERMONT STATE TREASURER'S OFFICE
PROXY VOTING POLICY STATEMENT AND GUIDELINES

This document sets forth the proxy voting policy and guidelines of the Vermont State Treasurer's Office and Vermont's three state-sponsored defined benefit pension funds, herein referred to as "Vermont." All investment managers for Vermont, herein referred to as "managers," responsible for the voting of our owned common stock are expected to take the following proxy voting policy and guidelines into consideration before making proxy voting decisions.

We expect our investment managers to vote our proxies solely in the best interest of plan participants and beneficiaries, and Vermont citizens. Investment managers are expected to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

The execution of proxy-voting rights at shareholder meetings is a required duty of pension fund fiduciaries. The U.S. Department of Labor (DOL) has stated that the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock and that trustees may delegate this duty to an investment manager. [1]

Our proxy voting guidelines are designed to help ensure that Vermont fulfills its statutory and common law obligations governing proxy voting, with the intent of maximizing the long-term economic benefits of its plan participants, beneficiaries, and citizens. This includes an obligation to vote our proxies in a manner consistent with sound corporate governance and responsible corporate practices. In our view, sound corporate governance and responsible corporate practices lead to increased shareholder value.

While these guidelines often provide explicit guidance on how we would like our proxies voted on specific types of issues, investment managers are expected to analyze each question on a case-by-case basis, informed by the guidelines elaborated herein, subject to the requirement that all votes shall be cast solely in the long-term interest of the participants and beneficiaries of the plans. Each proxy issue should be subject to a rigorous analysis of the economic impact of the issue on the long-term share value.

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[1] Many public sector pension plans, regulatory bodies, and professional associations have adopted the views of the U.S. Department of Labor on fiduciary duties related to proxy voting. The Department of Labor's Pension and Welfare Benefits Administration has stated in opinion letters and an interpretative bulletin that the voting rights related to shares of stock held by pension plans are plans assets. Therefore, according to the Department, "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock." Sources include: the Department of Labor Opinion Letter (Feb.23, 1988), reprinted in 15 Pens. Rep. (BNA), 391, the Department of Labor Opinion Letter (Jan.23, 1990), reprinted in 17 Pens. Rep. (BNA), 244 and the Interpretative Bulletin, 94-2.

Vermont does not intend for these guidelines to be exhaustive. Hundreds of issues appear on proxy ballots every year, and it is neither practical nor productive to fashion voting guidelines and policies which attempt to address every eventuality. Rather, these guidelines are intended to cover the most significant and frequent proxy issues that arise. Issues not covered by the guidelines shall be voted in the interest of the participants and beneficiaries of the plan. Vermont will revise its guidelines as circumstances warrant.

These proxy voting guidelines address a broad range of issues, including election of directors, executive compensation, proxy contests, mergers and acquisitions, and tender offer takeover defenses – voting items that can have great significance to the long-term value of pension fund assets. In addition to governance issues, these guidelines address broader issues of corporate citizenship that can also have a direct impact on corporate performance and important stakeholder interests, including the environment, job security and wage levels, local economic development and stability, and workplace safety and health issues. In accordance with state law, the policies take into consideration actions that promote good corporate citizenship through the proxy process.

Investment managers for Vermont are expected to provide quarterly vote summary reports on proxy votes cast on its behalf. These reports will be used to demonstrate consistency of manager voting with Vermont's stated policy. A copy of the *Proxy Voting Policy Statement & Guidelines* will be provided to each manager. Revised copies of this proxy voting policy statement and guidelines will be provided to managers whenever significant revisions have been made. Copies are also available online at our website: www.Vermontreasurer.gov.

Disclaimer: In January 2004, Vermont retained Institutional Shareholder Services Inc. to develop proxy voting policies and guidelines. ISS is the world's leading provider of proxy voting, shareholder advisory services, and corporate governance research. ISS serves more than 950 institutional and corporate clients worldwide with its core business — analyzing proxies and issuing informed research and objective vote recommendations for more than 10,000 U.S. and 12,000 non-U.S. shareholder meetings each year. For more information about ISS or to download a copy of the firm's Form ADV Part II, go to www.issproxy.com.

BOARD OF DIRECTORS

Electing directors is the single most important stock ownership right that shareholders can exercise. By electing directors who share their views, shareholders can help to define performance standards against which management can be held accountable.

According to the *Report of the National Association of Corporate Directors' Blue Ribbon Commission on Director Professionalism (1996):* "The accepted governance paradigm is simple: management is accountable to the board and the board is accountable to shareholders… In the view of the Commission, the board does more than mechanically link those who manage the corporation and those who own it. Rather, as a surrogate for dispersed ownership, the board is at the very center of corporate governance itself."

Vermont expects managers to hold directors to a high standard when voting on their election, qualifications, and compensation. Vermont managers should evaluate directors fairly and objectively, rewarding them for significant contributions and holding them ultimately accountable to shareholders for corporate performance. Institutional investors should use their voting rights in uncontested elections to influence financial performance and corporate strategies for achieving long-term shareholder value.

Voting on Director Nominees in Uncontested Elections

Votes concerning the entire board of directors and members of key board committees should be examined using the following five factors:

- Lack of independence[2] of the full board and key board committees (fully independent audit, compensation, and nominating committees);
- Diversity of board;
- Executive compensation related (excessive salaries/bonuses/pensions, history of repricing underwater stock options, imprudent use of company resources, misallocation of corporate assets, etc.);
- Failure of the board to properly respond to majority votes on shareholder proposals;
- Poor long-term corporate performance record relative to peer index and S&P 500 when necessary and in exceptional or tie-breaking circumstances.

Votes on individual director nominees should always be made on a CASE-BY-CASE basis. Specific withhold votes from individual director nominees may be triggered by one or more of the following factors:

- Lack of a board that is at least majority independent – i.e., where the composition of non-independent board members is in excess of 50 percent of the entire board;
- Attendance of director nominees at board meetings of less than 75 percent in one year without valid reason or explanation;
- Lack of independence on key board committees (i.e., audit, compensation, and nominating committees);
- Failure to establish any key board committees (i.e., audit, compensation, or nominating);

[2] For the methodology Vermont uses to classify individual directors' nominees, see addendum 1.

• Directors serving on an excessive number of other boards which could compromise their primary duties of care and loyalty;
• Chapter 7 bankruptcy, SEC violations, and criminal investigations by the Department of Justice (DOJ) and/or other federal agencies;
• Interlocking directorships;
• Performance of compensation committee members related to the approval of egregious executive compensation (both cash and equity awards);
• Performance of audit committee members concerning the approval of excessive non-audit fees and/or the lack of auditor ratification upon the proxy ballot.

Voting for Director Nominees in Contested Elections

Contested elections of directors frequently occur when a board candidate or "dissident slate" seeks election for the purpose of achieving a significant change in corporate policy or control of seats on the board. Competing slates should be evaluated on a CASE-BY-CASE basis with a number of considerations in mind. These include, but are not limited to, the following: personal qualifications of each candidate; the economic impact of the policies advanced by the dissident slate of nominees; and their expressed and demonstrated commitment to the interests of the shareholders of the company.

Votes in a contested election of directors should be evaluated on a CASE-BY-CASE basis, with the following seven factors in consideration:

• Long-term financial performance of the target company relative to its industry in exceptional or tie-breaking circumstances;
• Management's historical track record;
• Background to the proxy contest;
• Qualifications of director nominees (both slates);
• Evaluation of what each side is offering shareholders as well as the likelihood that the proposed objectives and goals in these proposals are realistic, achievable, demonstrable, and viable under the current conditions by which the company operates;
• Equity ownership positions;
• Total impact on all stakeholders.

On occasion, Vermont may provide specific voting instructions to its managers pertaining to high profile proxy contests, "vote no" initiatives, or contested transactions. In these select instances, managers of the funds will be expected to execute Vermont voting instructions in good faith.

CEO Serving as Chairman

Arguments have been made that a smaller company and its shareholders can benefit from the full-time attention of a joint chairman/CEO. This may be so in select cases, and indeed, using a case-by-case review of circumstances, there may be worthy exceptions. But even in these cases, it is our general view that a person should serve in the position of joint CEO and chairman only on a temporary basis. Once a company reaches a point of maturity, these positions should be separated. Clearly, the prevalence of joint CEO/Chairman positions in boardrooms has stretched well beyond the small-cap universe of companies. Today, roughly two-thirds of companies in both the S&P 500 and Russell 3000 fall into this category.

We strongly believe that the potential for conflicts of interest in the board's supervisory and oversight duties trumps any possible corollary benefits that could ensue from a dual CEO/chairman scenario. Instead of having an ingrained *quid pro quo* situation whereby a company has a single leader overseeing both management and the boardroom, we believe that it is the board's implicit duty to assume an impartial and objective role in overseeing the executive team's overall performance. Shareholder interests are placed in jeopardy if the CEO of a company is required to report to a board that she/he also chairs. Inherent in the chairman's job description is the duty to assess the CEO's performance. This objectivity is obviously compromised when a chairman is in charge of evaluating her/his own performance. Moreover, the unification of chairman and CEO poses a direct threat to the smooth functioning of the entire board process since it is the ultimate responsibility of the chairman to set the agenda, facilitate discussion, and make sure that directors are given complete access to information in order to make informed decisions.

Two major components at the top of every public company are the running of the board and the executive responsibility for the running of the company's business. Without doubt, there should be a clear division of responsibilities at the head of the company that will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. When there is no clear division between the executive and board branches of a company, poor executive and/or board actions often go unchecked to the ultimate detriment of shareholders. Since executive compensation is so heavily correlated to the managerial power relationship in the boardroom, the separation of the CEO and chairman positions is a critical step in curtailing excessive pay, which ultimately can become a drain on shareholder value. Indeed, a number of academic studies have demonstrated that executive compensation is 20 to 40 percent higher if the CEO is also the chairman of the board.

Vermont managers should:

• Generally WITHHOLD votes from a CEO who is also serving in the role of chairman at the same company;
• Generally support shareholder proposals calling for the separation of the CEO and chairman positions; and
• Generally support shareholder proposals calling for a non-executive director to serve as chairman who is not a former CEO or senior-level executive of the company.

Independent Directors

Vermont believes that a board independent from management is of vital importance to a company and its shareholders. Accordingly, Vermont expects votes to be cast in a manner that shall encourage the independence of boards. Independence will be evaluated based upon a number of factors, including: employment by the company or an affiliate in an executive capacity; past or current employment by a firm that is one of the company's paid advisors or consultants; personal services contract with the company; family relationships of an executive or director of the company; interlocks where two CEOs/Chairmen serve on each others' boards; instances where directors serve on more than one board (and key committees) together; and service with a non-profit that receives significant contributions from the company.

Vermont managers should:

• Generally WITHHOLD votes from non-independent board members (insiders and affiliated outsiders) where the board is not at least a majority (50+%) independent;
• Generally consider independent board members who have been on the board continually for a period longer than 10 years as affiliated outsiders;
• Vote FOR shareholder proposals requesting that all key board committees (i.e., audit, compensation,and/or nominating) include independent directors exclusively;
• Vote FOR shareholder proposals requesting that the board be comprised of a two-thirds majority of independent directors.

Excessive Directorships

Recent regulations have been mandated that directors be more engaged in protecting shareholder interests or else risk civil and/or criminal sanctions. As such, board members must devote more time and effort to their oversight duties which, on average, were estimated to run to 300 hours per year per board for 2003. Recent surveys of directors also confirm a desire for limiting board memberships, generally to three-to-five seats. In view of the increased demands placed on board members, Vermont believes that directors who are overextended may be jeopardizing their ability to serve as effective representatives of shareholders. We expect votes to be withheld from directors serving on an excessive number of other boards, which could compromise their primary duties of care and loyalty.

Vermont managers should:

• Generally WITHHOLD votes from directors serving on an excessive number of boards. As a general rule, Vermont will withhold votes against board members (CEOs and non-CEOs nominees) serving on a total of more than six total boards.

Director Diversity

We support gender and ethnic diversity as an important component of a company's board. Diversity brings different perspectives to a board that in turn lead to a more varied approach to board issues. We believe that increasing diversity in the boardroom to better reflect a company's workforce, customers, and community enhances shareholder value.

Vermont managers should:

• Support proposals asking the board to make greater efforts to search for qualified female and minority candidates for nomination to the board of directors;
• Support endorsement of a policy of board inclusiveness; and

• Support reporting to shareholders on a company's efforts to increase diversity and stakeholder participation on their boards.

Stock Ownership Requirements

Corporate directors should own some amount of stock of the companies on which they serve as board members. Stock ownership is a simple method to align the interests of directors with company shareholders. Nevertheless, many highly qualified individuals such as academics and clergy who can offer valuable perspectives in board rooms may be unable to purchase individual shares of stock. In such a circumstance, the preferred solution is to look at the board nominees individually and take stock ownership into consideration when voting on the merits of each candidate.

Vermont managers should:

• Vote AGAINST shareholder proposals requiring directors to own a minimum amount of company stock in order to qualify as a director nominee or to remain on the board.

Classified Boards / Annual Elections

The ability to elect directors is the single most important use of the shareholder franchise, and all directors should be accountable on an annual basis. Annually elected boards provide the best governance system for accountability to shareholders. A classified board is a board that is divided into separate classes, with directors serving overlapping terms. A company with a classified board usually divides the board into three classes. Under this system, only one class of nominees comes up to shareholder vote at the AGM each year.

As a consequence of these staggered terms, shareholders only have the opportunity to vote on a single director approximately once every three years. A classified board makes it difficult to change control of the board through a proxy contest, since it would normally take two years to gain control of a majority of board seats. Under a classified board, the possibility of management entrenchment greatly increases.

Many in management believe that staggered boards provide continuity. Some shareholders believe that in certain cases a staggered board can provide consistency and continuity in regard to decision-making and commitment that may be important to the long-term financial future of the company.

Nevertheless, empirical evidence suggests that staggered boards may not in all cases be in the shareholders' best interests. A classified board can entrench management and effectively preclude most takeover bids or proxy contests.

Vermont managers should:

• Vote AGAINST classified boards when the issue comes up for vote.

Board and Committee Size

While there is no hard and fast rule among institutional investors as to what may be an optimal size board, Vermont believes there is an acceptable range which companies should strive to meet and not exceed. A board that is too large may function inefficiently. Conversely, a board that is too small may allow the CEO to exert disproportionate influence or may stretch the time requirements of individual directors too thin.

Vermont expects proposals seeking to set board size to be evaluated on a CASE-BY-CASE basis. Given that the preponderance of boards in the U.S. range between five and 15 directors, we believe this is a useful benchmark for evaluating such proposals.

Vermont managers should:

- Generally vote AGAINST any proposal seeking to amend the company's board size to fewer than five seats;
- Generally vote AGAINST any proposal seeking to amend the company's board size to more than 15 seats; and
- Evaluate board size on a CASE-BY-CASE basis and consider WITHHOLDS or other action at companies that have fewer than five directors and more than 15 directors on their board.

Limit Term of Office

Those who support term limits argue that this requirement would bring new ideas and approaches on to a board. Here again we prefer to look at directors as individuals rather than impose a strict rule. While term of office limitations can rid the board of non-performing directors over time, it can also unfairly force experienced and effective directors off the board.

Vermont managers should:

- Generally vote AGAINST shareholder proposals to limit the tenure of outside directors.

Cumulative Voting

Most corporations provide that shareholders are entitled to cast one vote for each share owned. Under a cumulative voting scheme, the shareholder is permitted to have one vote per share for each director to be elected. Shareholders are permitted to apportion those votes in any manner they wish among the director candidates. Shareholders have the opportunity to elect a minority representative to a board through cumulative voting, thereby ensuring representation for all sizes of shareholders.

For example, if there is a company with a ten-member board and 500 shares outstanding—the total number of votes that may be cast is 5,000. In this case, a shareholder with 51 shares (10.2 percent of the outstanding shares) would be guaranteed one board seat because all votes may be cast for one candidate. Without cumulative voting, anyone controlling 51 percent of shares would control the election of all ten directors.

Shareholders need to have flexibility in supporting candidates for a company's board of directors. This is the only mechanism that minority shareholders can use to be represented on a company's board.

Vermont managers should:

• Vote AGAINST proposals to eliminate cumulative voting; and
• Vote FOR proposals to permit cumulative voting.

Director and Officer Indemnification and Liability Protection

Management proposals typically seek shareholder approval to adopt an amendment to the company's charter to eliminate or limit the personal liability of directors to the company and its shareholders for monetary damages for any breach of fiduciary duty to the fullest extent permitted by state law. In contrast, shareholder proposals seek to provide for personal monetary liability for fiduciary breaches arising from gross negligence. While Vermont recognizes that a company may have a more difficult time attracting and retaining directors if they are subject to personal monetary liability, Vermont believes the great responsibility and authority of directors justifies holding them accountable for their actions.

Each proposal addressing director liability should be evaluated consistent with this philosophy. Vermont managers may support these proposals when the company persuasively argues that such action is necessary to attract and retain directors, but Vermont managers may often oppose management proposals and support shareholder proposals in light of our philosophy of promoting director accountability.

Vermont managers should:

• Vote AGAINST proposals to limit or eliminate entirely director and officer liability in regards to: (i) breach of the director's fiduciary "duty of loyalty" to shareholders; (ii) acts or omissions not made in "good faith" or involving intentional misconduct or knowledge of violations under the law; (iii) acts involving the unlawful purchases or redemptions of stock; (iv) payment of unlawful dividends; or (v) use of the position as director for receipt of improper personal benefits.

Indemnification

Indemnification is the payment by a company of the expenses of directors who become involved in litigation as a result of their service to a company. Proposals to indemnify a company's directors differ from those to eliminate or reduce their liability because with indemnification directors may still be liable for an act or omission, but the company will bear the expense. Vermont managers may support these proposals when the company persuasively argues that such action is necessary to attract and retain directors, but should generally oppose indemnification when it is being proposed to insulate directors from actions they have already taken.

Vermont managers should:

• Vote AGAINST indemnification proposals that would expand individual coverage beyond ordinary legal expenses to also cover specific acts of negligence which exceed the standard of mere carelessness that is regularly covered in board fiduciary indemnification; and
• Vote FOR only those proposals which provide expanded coverage in cases when a director's or officer's legal defense was unsuccessful if: (1) the director was found to have acted in good faith and in a manner that he/she reasonably believed was in the best interests of the company; and (2) only if the director's legal expenses would be covered.

Poison Pills

Shareholder rights plans, typically known as poison pills, take the form of rights or warrants issued to shareholders and are triggered when a potential acquiring stockholder reaches a certain threshold of ownership. When triggered, poison pills generally allow shareholders to purchase shares from, or sell shares back to, the target company ("flip-in pill") and/or the potential acquirer ("flip-out pill") at a price far out of line with fair market value.

The most lethal variation of the poison pill is a "dead-hand" pill. The dead-hand pill is an especially noxious anti-takeover device designed to prevent the acquisition of a company even if a majority of shareholders favor the acquisition. What makes dead-hands so problematic is that they can only be removed by incumbent directors or chosen successors. The Delaware Chancery Court ruled in 1998 that dead-hand shareholder rights plans violate Delaware law. In striking down the dead-hand pill, the court declared that it lacked statutory authority under Delaware General Corporation law because it "limited in a substantial way the freedom of [newly elected] directors' decisions on matters of management policy and violated the duty of each [newly elected] director to exercise his own best judgment on matters coming before the board."[3]

Depending on the type of pill, the triggering event can either transfer wealth from the target company or dilute the equity holdings of current shareholders. Poison pills insulate management from the threat of a change in control and provide the target board with veto power over takeover bids. Because poison pills greatly alter the balance of power between shareholders and management, shareholders should be allowed to make their own evaluation of such plans.

Vermont managers should:

• Vote FOR shareholder proposals that ask a company to submit its poison pill for shareholder ratification;
• Review CASE-BY-CASE shareholder proposals to redeem a company's poison pill;
• Review CASE-BY-CASE management proposals to ratify a poison pill;
• Votes should be WITHHELD from any board where a dead-hand poison pill provision is in place. From a shareholder perspective, there is no justification for a dead-hand provision. Directors of companies with these lethal protective devices should be held accountable.

Greenmail

Greenmail payments are targeted share repurchases by management of company stock from individuals or groups seeking control of the company. Since only the hostile party receives payment, usually at a substantial premium over the market value of shares, the practice discriminates against most shareholders. This transferred cash, absent the greenmail payment, could be put to much better use for reinvestment in the company, payment of dividends, or to

[3] 721 A.2d 1281 (Del. 1998)

fund a public share repurchase program.

Vermont managers should:

• Vote FOR proposals to adopt an anti-greenmail provision in their charter or bylaws that would thereby restrict a company's ability to make greenmail payments to certain shareholders; and
• Review on a CASE-BY-CASE basis all anti-greenmail proposals when they are presented as bundled items with other charter or bylaw amendments.

Shareholder Ability to Remove Directors

Shareholder ability to remove directors, with or without cause, is either prescribed by a state's business corporation law, individual company's articles of incorporation, or its corporate bylaws. Many companies have sought shareholder approval for charter or bylaw amendments that would prohibit the removal of directors except for cause, thus ensuring that directors would retain their directorship for their full-term unless found guilty of self-dealing. By requiring cause to be demonstrated through due process, management insulates the directors from removal even if a director has been performing poorly, not attending meetings, or not acting in the best interests of shareholders.

Vermont managers should:

• Vote AGAINST proposals that provide that directors may be removed only for cause;
• Vote FOR proposals that seek to restore the authority of shareholders to remove directors with or without cause;
• Vote AGAINST proposals that provide only continuing directors may elect replacements to fill board vacancies; and
• Vote FOR proposals that permit shareholders to elect directors to fill board vacancies.

Shareholder Ability to Alter the Size of the Board

Proposals that would allow management to increase or decrease the size of the board at its own discretion are often used by companies as a takeover defense. Vermont supports management proposals to fix the size of the board at a specific number, thus preventing management -- when facing a proxy context -- from increasing the board size without shareholder approval. By increasing the size of the board, management can make it more difficult for dissidents to gain control of the board. Fixing the size of the board also prevents a reduction in the size of the board as a strategy to oust independent directors. Fixing board size also prevents management from increasing the number of directors in order to dilute the effects of cumulative voting.

Vermont managers should:

• Vote FOR proposals that seek to fix the size of the board within an acceptable range; and
• Vote AGAINST proposals that give management the ability to alter the size of the board without shareholder approval.

AUDITORS

Auditors play an integral role in certifying the integrity and reliability of corporate financial statements on which investors rely to gauge the financial well being of a company. The recent auditor-facilitated debacles at Enron, WorldCom, and Tyco underscore the catastrophic consequences that investors can suffer when the audit process breaks down.

The wave of recent accounting scandals at these companies illuminates the need to ensure auditor independence in the face of selling consulting services to audit clients. At the Big Five (now Final Four) accounting firms, revenues from non-audit services grew from 13% of total revenues in 1981 to half of total revenue in 2000. A recent study of over 1,200 US companies in the S&P 500, Mid Cap, and Small Cap indices found that 72% of fees paid to auditors in 2002 were for non-audit services, exactly the same level as 2001. We believe that the ratio should be reversed, and that non-audit fees should make up no more than one-quarter of all fees paid to the auditor so as to properly discourage even the appearance of any undue influence upon an auditor's objectivity.

As auditors are the backbone upon which a company's financial health is measured, auditor independence is absolutely essential for rendering objective opinions upon which investors then rely. When an auditor is paid excessive consulting fees in addition to fees paid for auditing, the company-auditor relationship is left open to conflicts of interest.

Auditor Ratification

The ratification of auditors is an important component of good governance. In light of the Sarbanes-Oxley Act and increased shareholder scrutiny, some companies are opting to take auditor ratification off the ballot. Neglecting to include the ratification of auditors on the proxy takes away the fundamental shareholder right to ratify the company's choice of auditor. Whereas two years ago shareholder ratification of auditors might have been considered routine by many shareowners, the subsequent accounting scandals have caused shareholders to be more vigilant about the integrity of the auditors certifying their companies' financial statements.

Although US companies are not legally required to allow shareholders to ratify their appointment of independent auditors, roughly 60% of S&P 500 companies allow for shareholder ratification of their auditors. Submission of the audit firm for approval at the annual meeting on an annual basis gives shareholders the means to weigh in on their satisfaction (or lack thereof) on the audit firm's independent execution of its duties. We firmly believe mandatory auditor ratification is in line with sound and transparent corporate governance and remains an important mechanism to ensure the integrity of the auditor's work. In the absence of legislation mandating shareholder ratification of auditors, the failure by a company to present its selection of auditors for shareholder ratification should be discouraged, as it undermines good governance and disenfranchises shareholders.

Because accounting scandals evaporate shareholder value, any proposal to ratify auditors should be examined for potential conflicts of interest, with particular attention to the fees paid to the auditor, as well as whether the ratification of auditors has been put up for shareholder vote.

Vermont managers should:

• Vote FOR proposals to ratify auditors when the amount of audit fees is equal to or greater than three times (75 percent) the amount paid for consulting, unless: i) An auditor has a financial interest in or association with the company, and is therefore not independent; or ii) There is reason to believe that the independent auditor has rendered an opinion which is neither accurate nor indicative of the company's financial position;
• Vote AGAINST proposals to ratify auditors when the amount of non-audit consulting fees exceeds a quarter of all fees paid to the auditor;
• WITHHOLD votes from Audit Committee members in cases where consulting fees exceed audit fees; and
• WITHHOLD votes from Audit Committee members when auditor ratification is not included on the proxy ballot.

Auditor Rotation

Long-term relationships between auditors and their clients can impede auditor independence, objectivity, and professional skepticism. Such long-standing relationships foster an undesirable coziness between audit firms and their clients, which can cause the auditors to lose their independence and become less questioning especially where lucrative contracts for the provision of non-audit consulting services are involved. Mandatory auditor rotation is a widely supported safeguard against improper audits and is viewed by many as an effective mechanism for mitigating the potential risks borne by long-term auditor-client relationships. Proponents of compulsory audit firm rotation contend that rotation policies promote objectivity and independence among auditors and minimize the scope of vested interests developing in the audit.

Opponents of audit firm rotation argue that regular re-tendering is costly, likely to reduce audit quality, and increase the risk of audit failure in the early years due to the time required to gain cumulative knowledge of an often complex and geographically diverse business. A solution around this apparent negative effect of mandatory rotation is to keep a longer rotation period.

In general, Vermont believes that companies should not maintain the same audit firm in excess of seven years, and will consider voting against auditors if their tenure at a company exceeds seven years. A revolving seven-year rotation period allows the auditor to develop cumulative knowledge of a company's business and the effect of changes in the business along with the corresponding changes in its risks, thereby enhancing the quality of the audit and trammeling potential loss of auditor objectivity and independence. We consider the increased costs associated with compulsory auditor rotation to be a lesser evil vis-à-vis the larger evil of the costs to shareholders when the objectionable coziness between clients and long-standing auditors leads to gross erosion of shareholder value.

Vermont managers should:

• Generally support shareholder proposals to ensure auditor independence through measures such as mandatory auditor rotation (no less than every seven years); and

• Generally support shareholder proposals seeking to prohibit companies from buying consulting services from their auditor.

MERGERS & ACQUISITIONS

Votes on mergers and acquisitions should be considered on a CASE-BY-CASE basis, taking into account at least the following:

• Impact of the merger on shareholder value;
• Anticipated financial and operating benefits realizable through combined synergies;
• Offer price (cost vs. premium);
• Financial viability of the combined companies as a single entity;
• Was the deal put together in good faith? Were negotiations carried out at arm's length? Was any portion of the process tainted by possible conflicts of interest?;
• Fairness opinion (or lack thereof);
• Changes in corporate governance and their impact on shareholder rights;
• Impact on community stakeholders and employees in both workforces.

Fair Price Provisions

Fair price provisions were originally designed to specifically defend against the most coercive of takeover devises— the two-tiered, front-end-loaded tender offer. In such a hostile takeover, the bidder offers cash for enough shares to gain control of the target. At the same time, the acquirer states that once control has been obtained, the target's remaining shares will be purchased with cash, cash, and securities, or only securities. Since the payment offered for the remaining stock is, by design, less valuable than the original offer for the controlling shares, shareholders are forced to sell out early to maximize the value of their shares. Standard fair price provisions require that— absent board or shareholder approval of the acquisition— the bidder must pay the remaining shareholders the same price for their shares as for those that brought control.

Vermont managers should:

• Vote FOR fair price proposals as long as the shareholder vote requirement embedded in the provision is no more than a majority of disinterested shares; and
• Vote FOR shareholder proposals to lower the shareholder vote requirement in existing fair price provisions.

Corporate Restructuring

Votes concerning corporate restructuring proposals, including minority squeezeouts, leveraged buyouts, spin-offs, liquidations, and asset sales should be considered on a CASE-BY-CASE basis.

Appraisal Rights

Rights of appraisal provide shareholders who do not approve of the terms of certain corporate transactions the right to demand a judicial review in order to determine the fair value for their shares. The right of appraisal applies to mergers, sale of corporate assets, and charter amendments that may have a materially adverse effect on the rights of dissenting shareholders.

Vermont managers should:

• Vote FOR proposals to restore or provide shareholders with the right of appraisal.

Spin-offs

Votes on spin-offs should be considered on a CASE-BY-CASE basis depending on the tax and regulatory advantages, planned use of sale proceeds, market focus, and managerial incentives.

Asset Sales

Votes on asset sales should be made on a CASE-BY-CASE basis after considering the impact on the balance sheet/working capital, value received for the asset, and potential elimination of diseconomies.

Liquidations

Votes on liquidations should be made on a CASE-BY-CASE basis after reviewing management's efforts to pursue other alternatives, appraisal value of assets, and the compensation plan for executives managing the liquidation.

Changing Corporate Name

Vermont managers should vote FOR changing the corporate name in all instances if proposed and supported by management.

SHAREHOLDER RIGHTS

Confidential Voting

The confidential ballot ensures that voters are not subject to real or perceived coercion. In an open voting system, management can determine who has voted against its nominees or proposals before a final vote count. As a result, shareholders can be pressured to vote with management at companies with which they maintain or would like to establish a business relationship.

Vermont managers should:

• Vote FOR shareholder proposals that request corporations to adopt confidential voting, use independent tabulators, and use independent inspectors of election as long as the proposals include clauses for proxy contests as follows: in the case of a contested election, management is permitted to request that the dissident group honor its confidential voting policy. If the dissidents agree, the policy remains in place. If the dissidents do not agree, the confidential voting policy is waived; and
• Vote FOR management proposals to adopt confidential voting procedures.

Shareholder Ability to Call Special Meetings

Most state corporation statutes allow shareholders to call a special meeting when they want to take action on certain matters that arise between regularly scheduled annual meetings. Sometimes this right applies only if a shareholder or a group of shareholders own a specified percentage of shares, with ten percent being the most common. Shareholders may lose the ability to remove directors, initiate a shareholder resolution, or respond to a beneficial offer without having to wait for the next scheduled meeting if they are unable to act at a special meeting of their own calling.

Vermont managers should:

• Vote AGAINST proposals to restrict or prohibit shareholder ability to call special meetings; and
• Vote FOR proposals that remove restrictions on the right of shareholders to act independently of management.

Shareholder Ability to Act by Written Consent

Consent solicitations allow shareholders to vote on and respond to shareholder and management proposals by mail without having to act at a physical meeting. A consent card is sent by mail for shareholder approval and only requires a signature for action. Some corporate bylaws require supermajority votes for consents, while at others standard annual meeting rules apply. Shareholders may lose the ability to remove directors, initiate a shareholder resolution, or respond to a beneficial offer without having to wait for the next scheduled meeting if they are unable to act at a special meeting of their own calling.

Vermont managers should:

• Vote AGAINST proposals to restrict or prohibit shareholder ability to take action by written consent; and
• Vote FOR proposals to allow or make easier shareholder action by written consent.

Equal Access

Directors on a number of corporate boards have rewarded undeserving corporate executives with excessive compensation and retirement perks. Moreover, in too many situations stolid directors have remained uninformed or unwilling to challenge management with the tough questions their fiduciary duties and obligations require by law. Hard-learned lessons from recent corporate scandals have demonstrated that passive board behavior can lead to the deterioration of shareholder wealth, jobs, and local communities.

The current "take-it-or-leave-it" director election process as it exists leaves much to be desired. Companies currently nominate for election only one candidate for each board seat. Shareholders who oppose a candidate have no easy way to do so unless they are willing to undertake the considerable expense of running an independent candidate for the board. The only way for shareholders to register dissent about a given director candidate is to withhold support from that nominee.

On October 8, 2003, the SEC proposed historic corporate accountability proxy rules (proposal S7-19-03) that would give significant long-term shareholders greater ability to include their director nominees in management's proxy statement. By giving shareholders a voice in picking corporate directors, the reforms put forward by the SEC have the potential to put an end to the CEO cult and give shareholders far greater say in choosing the directors most able to represent their interests.

The SEC proposal entails a two-step, two-year process. In the first year (2004), one of two triggering events must occur: (1) One or more directors at a company receive withhold votes of 35 percent or more of the votes cast; or (2) A shareholder proposal asking for open access, which is submitted by holders of at least one percent of the shares (owned for at least one year), is approved by a majority of the votes cast.

If one of these conditions is met, then for the following two years (2005 and 2006), the company would be required to include in its proxy materials one or more board nominees (depending on the board size) proposed by holders of at least five percent of the shares (owned for at least two years).

Vermont espouses ballot access mechanisms for shareholders and supports well-targeted proxy-access proposals at companies where there are legitimate concerns surrounding responsiveness to shareholders (such as not implementing majority-supported shareholder proposals), board and key committee independence, compensation practices, and accounting and financial issues (such as restatements).

Vermont managers should:

• Vote FOR shareholder resolutions filed by one-percent, one-year shareholders that, if passed, will be binding on the company per the proposed SEC trigger; and
• Review CASE-BY-CASE predatory shareholder proposals asking companies to voluntarily adopt open access, perhaps at a different trigger than the SEC's proposed five-percent, two-year ownership threshold.

Unequal Voting Rights

Incumbent managers are able to use unequal voting rights through the creation of a separate class of shares which have superior voting rights to the common shares of regular shareholders. This separate class of shares with disproportionate voting power allows management to concentrate its power and insulate itself from the wishes of the majority of shareholders. Dual class exchange offers involve a transfer of voting rights from one group of shareholders to another group of shareholders typically through the payment of a preferential dividend. A dual class recapitalization plan also establishes two classes of common stock with unequal voting rights, but initially involves an equal distribution of preferential and inferior voting shares to current shareholders.

Vermont managers should:

• Vote FOR resolutions that seek to maintain or convert to a one share, one vote capital structure; and
• Vote AGAINST requests for the creation or continuation of dual class capital structures or the creation of new or additional super-voting shares.

Supermajority Shareholder Vote Requirement to Amend the Charter or Bylaws

Supermajority shareholder vote requirements for charter or bylaw amendments are often the result of "lock-in" votes, which are the votes required to repeal new provisions to the corporate charter. Supermajority provisions violate the principle that a simple majority of voting shares should be all that is necessary to effect change regarding a company and its corporate governance provisions. Requiring more than this may entrench managers by blocking actions that are in the best interests of shareholders.

Vermont managers should:

• Vote AGAINST management proposals to require a supermajority shareholder vote to approve charter and bylaw amendments;
• Vote AGAINST management proposals seeking to lower supermajority shareholder vote requirements when they accompany management-sponsored proposals to also change certain charter or bylaw amendments; and
• Vote FOR shareholder proposals to lower supermajority shareholder vote requirements for charter and bylaw amendments.

Supermajority Shareholder Vote Requirement to Approve Mergers

Supermajority provisions violate the principle that a simple majority of voting shares should be all that is necessary to effect change regarding a company and its corporate governance provisions. Requiring more than this may entrench managers by blocking actions that are in the best interests of shareholders.

Vermont managers should:

• Vote AGAINST management proposals to require a supermajority shareholder vote to approve mergers and other significant business combinations; and
• Vote FOR shareholder proposals to lower supermajority shareholder vote requirements for mergers and other significant business combinations.

Reimburse Proxy Solicitation Expenses

Decisions to provide full reimbursement for dissidents waging a proxy contest should be made on a CASE-BY-CASE basis.

CAPITAL STRUCTURE

The management of a corporation's capital structure involves a number of important issues including dividend policy, types of assets, opportunities for growth, ability to finance new projects internally, and the cost of obtaining additional capital. Many financing decisions have a significant impact on shareholder value, particularly when they involve the issuance of additional common stock, preferred stock, or debt.

Common Stock Authorization

State statutes and stock exchanges require shareholder approval for increases in the number of common shares. Corporations increase their supply of common stock for a variety of ordinary business purposes: raising new capital, funding stock compensation programs, business acquisitions, implementation of stock splits, or payment of stock dividends.

Vermont supports management proposals requesting shareholder approval to increase authorized common stock when management provides persuasive justification for the increase. For example, Vermont would support increases in authorized common stock to fund stock splits that are in shareholders' interests. Vermont managers should evaluate proposals on a CASE-BY-CASE basis when the company intends to use the additional stock to implement a poison pill or other takeover defense. Vermont managers should evaluate the amount of additional stock requested in comparison to the requests of the company's peers, as well as the company's articulated reason for the increase.

Vermont managers should:

• Review on a CASE-BY-CASE basis proposals to increase the number of shares of common stock authorized for issue; and
• Generally vote AGAINST proposed common stock authorizations that increase the existing authorization by more than fifty percent unless a clear need for the excess shares is presented by the company.

Reverse Stock Splits

Reverse splits exchange multiple shares for a lesser amount to increase share price. Increasing share price is sometimes necessary to restore a company's share price to a level that will allow it to be traded on the national stock exchanges. In addition, some brokerage houses have a policy of not monitoring or investing in very low priced shares. Reverse stock splits can help maintain stock liquidity.

Vermont managers should review management proposals to implement a reverse stock split on a CASE-BY-CASE basis, taking into account whether there is a corresponding proportional decrease in authorized shares. Managers should generally support a reverse stock split if management provides a reasonable justification for the split and reduces authorized shares accordingly. Without a corresponding decrease, a reverse stock split is effectively an increase in authorized shares by reducing the number of shares outstanding while leaving the number of authorized shares to be issued at the pre-split level.

Blank Check Preferred Authorization

Preferred stock is an equity security which has certain features similar to debt instruments— such as fixed dividend payments and seniority of claims to common stock— and usually carries little to no voting rights. The terms of blank check preferred stock give the board of directors the power to issue shares of preferred stock at their discretion with voting, conversion, distribution, and other rights to be determined by the board at time of issue. Blank check preferred stock can be used for sound corporate purposes, but can also be used as a device to thwart hostile takeovers without shareholder approval.

Vermont managers should:

• Vote FOR proposals to create blank check preferred stock in cases when the company expressly states that the stock will not be used as a takeover defense or carry superior voting rights;
• Review on a CASE-BY-CASE basis proposals that would authorize the creation of new classes of preferred stock with unspecified voting, conversion, dividend, distribution, and other rights;
• Review on a CASE-BY-CASE basis proposals to increase the number of authorized blank check preferred shares. If the company does not have any preferred shares outstanding, we will vote AGAINST the requested increase;
• Vote FOR shareholder proposals to have blank check preferred stock placements, other than those shares issued for the purpose of raising capital or making acquisitions in the normal course of business, submitted for shareholder ratification.

Adjust Par Value of Common Stock

Stock that has a fixed per share value that on its certificate is called par value stock. The purpose of par value stock is to establish the maximum responsibility of a stockholder in the event that a corporation becomes insolvent. Proposals to reduce par value come from certain state level requirements for regulatory industries, such as banks, and other legal requirements relating to the payment of dividends.

Vermont managers should:

• Vote FOR management proposals to reduce the par value of common stock.

Preemptive Rights

Preemptive rights permit shareholders to share proportionately in any new issues of stock of the same class. These rights guarantee existing shareholders the first opportunity to purchase shares of new issues of stock in the same class as their own and in the same proportion. The absence of these rights could cause stockholders' interest in a company to be reduced by the sale of additional shares without their knowledge and at prices unfavorable to them. Preemptive rights, however, can make it difficult for corporations to issue large blocks of stock for general corporate purposes. Both corporations and shareholders benefit when corporations are able to arrange issues without preemptive rights that do not result in a substantial transfer of control.

Vermont managers should:

• Review on a CASE-BY-CASE basis proposals to create or abolish preemptive rights. In evaluating proposals on preemptive rights, managers should look at the size of a company and the characteristics of its shareholder base.

Debt Restructuring

Vermont managers should review on a CASE-BY-CASE basis proposals to increase common and/or preferred shares and to issue shares as part of a debt restructuring plan.

Vermont managers should carefully consider the following issues:

• *Dilution*: How much will ownership interests of existing shareholders be reduced and how extreme will dilution to any future earnings be?
• *Change in Control*: Will the transaction result in a change in control of the company?
• *Bankruptcy*: How real is the threat of bankruptcy? Is bankruptcy the main factor driving the debt restructuring? Would the restructuring result in severe loss to shareholder value?
• *Possible self-dealings*: Generally approve proposals that facilitate debt restructuring unless there are clear signs of self-dealing or other abuses.

COMPENSATION

Stock Option Plans

Vermont supports compensating executives at a reasonable rate and believes that executive compensation should be strongly correlated to performance. Stock options, restricted stock, and other forms of non-cash compensation should be performance-based with an eye toward improving long-term shareholder value. Well-designed stock option plans can align the interests of executives and shareholders by providing that executives benefit when stock prices rise as the company— and shareholders— prosper together.

Many plans sponsored by management provide goals so easily attained that executives can realize massive rewards even though shareholder value is not necessarily created. Vermont supports option plans that provide legitimately challenging performance targets that serve to truly motivate executives in the pursuit of long-term performance goals. Likewise, we oppose plans that offer unreasonable benefits to executives that are not available to any other shareholders. Among other features of the plan that may not be in shareholders' best interests, Vermont managers should take into consideration the following factors before voting on related questions.

Methodology for Analyzing Equity Pay Plans

In general, managers should consider executive and director compensation plans on a CASE-BY-CASE basis. When evaluating executive and director compensation matters, please review the following elements:

<u>Primary Considerations</u>:
• *Dilution*: Vote AGAINST plans in which the potential voting power dilution (VPD) of all shares outstanding exceeds 10 percent;
• *Full Market Value*: Awards must be granted at 100 percent of fair market value on the date of grant. However, in instances when a plan is open to broad-based employee participation and excludes the five most highly compensated employees, we accept a 15 percent discount;
• *Stock Option Expensing*: Vote AGAINST plans if the company does not fully expense its stock options.

<u>Secondary Considerations</u>:
• *Burn Rate*: Vote AGAINST plans where the annual burn rate exceeds industry and index burn rates over a three-year period;
• *Pay-For-Performance Metric*: Vote AGAINST plans where CEO pay and the company's performance is incongruous, as measured against industry peers over both one and three-year periods;
• *Evergreen Features*: Vote AGAINST plans that reserve a specified percentage of outstanding shares for award each year instead of having a termination date;
• *Repricing*: Vote AGAINST plans if the company's policy permits repricing of "underwater" options or if the company has a history of repricing past options. In those instances when repricing is put up for a shareholder vote, we will vote FOR the repricing of shares under the following four conditions: 1) The repricing represents a "value for value" exchange; 2) If the five

most highly compensated employees are excluded from the repricing; 3) If the plan is broad-based; and 4) If the current vesting schedule is maintained.

Dilution Calculation

Voting power dilution, or VPD, measures the amount of voting power represented by the number of shares reserved over the life of the plan. Industry norms dictate that ten percent dilution over the life of a ten-year plan is reasonable for most mature companies. Restricted stock plans or stock bonus plans which stand alone and are not coupled with stock option plans can be held to a lower dilution cap.

Voting power dilution may be calculated using the following formula:
A = Shares reserved for this amendment or plan;
B = Shares available under this plan and/or continuing plans prior to proposed amendment;
C = Shares granted but unexercised under this plan and/or continuing plans;
D = All outstanding shares plus any convertible equity, outstanding warrants, or debt.

The formula can be applied as follows:

$$\frac{A + B + C}{A + B + C + D}$$

Fair Market Value, Dilution, and Repricing

Vermont managers should consider whether the proposed plan is being offered at fair market value or at a discount; whether the plan excessively dilutes the earnings per share of the outstanding shares; and whether the plan gives management the ability to replace or reprice "underwater" options. Repricing is an amendment to a previously granted stock option contract that reduces the option exercise price. Options are "underwater" when their current price is below the current option contract price. Options can also be repriced through cancellations and re-grants. The typical new grant would have a ten-year term, new vesting restrictions, and a lower exercise price reflecting the current lower market price.

Burn Rate

Vermont managers should examine the annual burn rate, which is a measure of dilution that illustrates how rapidly a company is deploying shares reserved for equity compensation plans. The burn (or run) rate is calculated by dividing the number of shares pursuant to awards granted in a given year by the number of shares outstanding. Managers should benchmark a company's burn rate against three-year industry and primary index burn rates, and generally oppose plans whose burn rates exceed both industry and index burn rates over a three-year period.

Principle of Pay-for-Performance

Vermont acknowledges that stock-based pay is often the main driver for excessive executive compensation, which is fueled by poor administration of the plan. High levels of compensation are tangled up with corporate shenanigans and illegal activity as evidenced in Tyco, Enron, and WorldCom. Managers should, therefore, closely examine any discrepancies between increases in CEO pay and total shareholder returns against those of peer firms over a one- and three-year time frame in assessing equity-based compensation plans.

We believe significant disparities between pay and performance warrant withholding votes from Compensation Committee members who are responsible for overseeing the company's compensation schemes. If the equity component is the source of the imbalance, Vermont managers should oppose the equity plan in which the CEO participates.

Evergreen Provisions

Vermont also opposes plans that reserve a specified percentage of outstanding shares for award each year (evergreen plans) instead of having a termination date. Such plans provide for an automatic increase in the shares available for grant with or without limits on an annual basis. Because they represent a transfer of shareholder value and have a dilutive impact on a regular basis, evergreen plans are expensive to shareholders. Evergreen features also minimize the frequency that companies seek shareholder approval in increasing the number of shares available under the plan.

Restricted Stock

Vermont supports the use of performance-vesting restricted stock so long as the absolute amount of restricted stock being granted is a reasonable proportion of an executive's overall compensation. The best way to align the interests of executives with shareholders is through direct stock holdings, coupled with at-risk variable compensation that is tied to explicit and challenging performance benchmarks. Performance-vesting restricted stock both adds to executives direct share holdings and incorporates at-risk features.

To reward performance and not job tenure, restricted stock vesting requirements should be performance-based rather than time-lapsing. Such plans should explicitly define the performance criteria for awards to senior executives and may include a variety of corporate performance measures in addition to the use of stock price targets. In addition, executives should be required to hold their vested restricted stock as long as they remain employees of the company.

Stock Option Expensing

The theory that stock options are beneficial to shareholders because they motivate management and align the interests of investors with those of executives is no longer held sacrosanct. The fact that companies reprice underwater options exposes the initial fallacy of this theory. A recent long-term study of stock option awards from the Indiana University School of Business found that there was no correlation whatsoever between executive stock ownership and company performance. Given their accounting treatment of not being charged as an expense against earnings, stock options have been the ultimate tax dodge for companies wishing to lavishly compensate employees.

Misused stock options can give executives an incentive to inflate their company's earnings or make irresponsibly optimistic forecasts in order to keep stock prices high and their paychecks gargantuan. Alan Greenspan cautioned that the failure to expense stock option grants has "introduced a significant distortion in reported earnings, one that has grown with the increasing prevalence of this form of compensation." Some companies have chosen to acknowledge the distortion caused by the non-expensing of options and have committed to expense options going forward. Beginning in 2003, the SEC no longer excludes stock option expensing proposals from the proxy ballot using the ordinary business exception rules.

Vermont managers should support shareholder resolutions calling for stock option grants to be treated as an expense for accounting and earnings calculation purposes and opposes the use of stock options if the stock options are not fully expensed.

Executive Holding Periods

Vermont believes senior level executives should be required to hold a substantial portion of their equity compensation awards, including shares received from option exercises (e.g., 75% of their after-tax stock option proceeds), while they are employed at a company. Equity compensation awards are intended to align management interests with those of shareholders, and allowing executives to sell these shares while they are employees of the company undermines this purpose. Given the large size of a typical annual equity compensation award, holding requirements that are based on a multiple of cash compensation may be inadequate.

Performance-Based Options

Stock options are intended to align the interests of management with those of shareholders. However, stock option grants without performance-based elements can excessively compensate executives for stock increases due solely to a general stock market rise, rather than improved or superior company stock performance. When option grants reach the hundreds of thousands, a relatively small increase in the share price may permit executives to reap millions of dollars without providing material benefits to shareholders.

Vermont advocates performance based options, such as premium-priced or indexed, which encourage executives to outperform rivals and the market as a whole rather than being rewarded for any rise in the share price, which can occur if there are not empirical performance measures incorporated into the structure of the options. Additionally, it should be noted that performance-accelerated vesting and premium priced options allow fixed plan accounting, whereas performance-vested and indexed options entail certain expensing requirements.

Vermont managers should:

• Generally vote FOR shareholder proposals that seek to provide for performance-based options such as indexed and/or premium priced options.

Shareholder Proposals to Limit Executive and Director Pay

Vermont managers should:

• Generally vote FOR shareholder proposals that seek additional disclosure of executive and director pay information. Current SEC requirements only call for the disclosure of the top five most highly compensated executives and only if they earn more than $100,000 in salary and benefits;
• Generally vote FOR shareholder proposals that seek to eliminate outside directors' retirement benefits; and
• Review on a CASE-BY-CASE basis all other shareholder proposals that seek to limit executive and director pay. This includes shareholder proposals that seek to link executive compensation to customer, employee, or stakeholder satisfaction.

Golden and Tin Parachutes

Golden parachutes are designed to protect the employees of a corporation in the event of a change-in-control. Under most golden parachute agreements, senior level management employees receive a lump sum pay-out triggered by a change-in-control at usually two to three times base salary. Increasingly, companies that have golden parachute agreements for senior level executives are extending coverage for all their employees via "tin" parachutes. The SEC requires disclosure of all golden parachute arrangements in the proxy statement, while disclosure of tin parachutes in company filings is not required at this time.

Vermont managers should:

• Vote FOR shareholder proposals to have all golden and tin Parachute agreements submitted for shareholder ratification;
• Generally vote AGAINST all management sponsored proposals to ratify golden parachutes; and
• Consider tin parachutes on a CASE-BY-CASE basis.

Executive Perquisites and Retirement Benefits

Vermont supports enhanced disclosure and shareholder oversight of executive benefits and other in-kind retirement perquisites. For example, compensation devices like executive pensions (SERPs), deferred compensation plans, below-market-rate loans, or guaranteed post-retirement consulting fees can amount to significant liabilities to shareholders and it is often difficult for investors to find adequate disclosure of their full terms. In general, we oppose the provision of any perquisite or benefit to executives that exceeds what is generally offered to other company employees. From a shareholder prospective, the cost of these executive entitlements would be better allocated to performance-based forms of executive compensation during their term in office.

Employee Stock Ownership Plans (ESOPs)

An Employee Stock Ownership Plan (ESOP) is an employee benefit plan that makes the employees of a company also owners of stock in that company. Recently, a large Rutgers University study of the performance of ESOPs in closely held companies found that ESOPs appear to increase overall sales, employment, and sales per employee over what would have been expected absent an ESOP. The study also found that ESOP companies are also more likely to still be in business several years later, and are more likely to have other retirement-oriented benefit plans than comparable non-ESOP companies.

Vermont managers should:

• Vote FOR proposals that request shareholder approval in order to implement an ESOP or to increase authorized shares for existing ESOPs except in cases when the number of shares allocated to the ESOP is deemed "excessive" (i.e., generally greater than five percent of outstanding shares).

OBRA Related Compensation Proposals

The enactment of Section 162(m) in OBRA[4] has provided shareholders a set of proxy voting decisions to make with respect to executive compensation which go beyond the familiar task of evaluating stock option plans and other equity-based incentive plan proposals. In addition to considering plan amendments to incorporate administrative features, companies must for the first time submit equity plan performance targets as well as cash or cash-and-stock bonus plans to shareholders for approval in order to preserve the deductibility of bonus amounts over $1 million. With the new rules in place, shareholders supposedly have a greater ability to influence corporate policy with respect to the variable component of executive pay. However, failure to approve the amendment may mean that compensation exceeding the $1 million limit will be nondeductible. Shareholders still do not have a direct say over salary, the fixed-pay component.

Vermont managers should:

• Vote FOR amendments that place a cap on annual grants or amend administrative features;
• Vote FOR plans that simply amend shareholder-approved plans to include administrative features or place a cap on the annual grants that any one participant may receive in order to comply with the provisions of Section 162(m) of OBRA.

Amendments to Add Performance-Based Goals

Section 162(m) of the Internal Revenue Code limits the deductibility of compensation in excess of $1 million to a named executive officer in any given year, unless certain prescribed actions are taken including shareholder approval and the establishment of performance goals.

[4] Omnibus Budget Reconciliation Act

Vermont managers should:

• Vote FOR amendments to add performance goals to existing compensation plans to comply with the provisions of Section 162(m) of OBRA.

Amendments to Increase Shares and Retain Tax Deductions Under OBRA

Amendments to existing plans to increase shares reserved and to qualify the plan for favorable tax treatment under the provisions of Section 162(m) should be evaluated on a CASE-BY-CASE basis.

Approval of Cash or Cash-and-Stock Bonus Plans

Vermont managers should:

• Generally vote AGAINST cash or cash-and-stock bonus plans to exempt the compensation from taxes under the provisions of Section 162(m) of OBRA if the plan provides for awards to individual participants in excess of $2 million a year; and
• Vote AGAINST plans that are deemed to be "excessive" because they are not justified by performance measures.

State of Incorporation

Voting on State Takeover Statutes

Vermont managers should review, on a CASE-BY-CASE basis, proposals to opt in or out of state takeover statutes (including control share acquisition statutes, control share cash-out statutes, freezeout provisions, fair price provisions, stakeholder laws, poison pill endorsements, severance pay and labor contract provisions, anti-greenmail provisions, and disgorgement provisions). We generally support opting into stakeholder protection statutes if they provide comprehensive protections for employees and community stakeholders. We would be less supportive of takeover statutes that only serve to protect incumbent management from accountability to shareholders and that negatively influence shareholder value.

Offshore Re-incorporations & Tax Havens

While Vermont generally opposes offshore re-incorporation, for a company that seeks an offshore move, managers should evaluate the merits of questions relating to a move on a CASE-BY-CASE basis, taking into consideration the company's strategic rationale for the move, the potential economic ramifications, potential tax benefits, and any corporate governance changes that may impact shareholders. We believe there are a number of concerns associated with a company looking to reincorporate from the United States to exotic locales such as Bermuda, the Cayman Islands, or Panama. The trend of U.S. companies seeking to move offshore appears to be on the rise, and shareholders are just beginning to understand the web of complexities surrounding the legal, tax, and governance implications involved in such a transaction.

When reviewing a proposed offshore move, Vermont managers should consider the following factors:

- Legal recourse for US stockholders of the new company and the enforcement of legal judgments against the company under the US securities laws;
- The transparency (or lack thereof) of the new locale's legal system;
- Adoption of any shareholder-unfriendly corporate law provisions;
- Actual, qualified tax benefits;
- Potential for accounting manipulations and/or discrepancies;
- Any pending US legislation concerning offshore companies;
- Prospects of reputational harm and potential damage to brand name via increased media coverage concerning corporate expatriation.

Furthermore, while taking the above factors into consideration, Vermont managers should generally support shareholder requests calling for "expatriate" companies that are domiciled abroad yet predominantly owned and operated in America to re-domesticate back to a U.S. state jurisdiction.

Special Policy Review and Shareholder Advisory Committees

These resolutions propose the establishment of special committees of the board to address broad corporate policy and provide forums for ongoing dialogue on issues including, but not limited to: shareholder relations, the environment, occupational health and safety, and executive compensation.

• Vermont managers should support these proposals when they appear to offer a potentially effective method for enhancing shareholder value.

Political Contributions Reporting

Vermont believes employees should not be put in a position where professional standing and goodwill within the corporation could be jeopardized as a result of political beliefs. Responsible employment practices should protect workers from an environment characterized by political indoctrination or intimidation. Corporations should not devote resources to partisan political activities, nor should they compel their employees to contribute to or support particular causes.

Moreover, we believe it is wise for a corporation to maintain a politically neutral stance so as to avoid potentially embarrassing conflicts of interests that could negatively impact the company's brand name with consumers. Shareholders have the right to know about corporate political activities, and management's knowledge that such information can be made publicly available should encourage a company's lawful and responsible use of political contributions.

Vermont managers should:

• Support proposals affirming political non-partisanship;
• Support reporting of political and political action committee (PAC) contributions; and
• Support establishment of corporate political contributions guidelines and reporting provisions.

Equal Employment Opportunity, Diversity, and Other Work Place Practice Issues

Many proposals generally request that a company establish a policy of reporting to shareholders its progress with equal opportunity and affirmative action programs. The costs of violating federal laws that prohibit discrimination by corporations are high and can affect corporate earnings.

The Equal Opportunities Employment Commission (EEOC) does not release the company's filings to the public unless it is involved in litigation, and the information is difficult to obtain from other sources. Companies need to be very sensitive to minority employment issues as the new evolving work force becomes increasingly diverse. This information can be provided with little cost to the company and does not create an unreasonable burden on management.

Violations of workplace anti-discrimination laws lead to expensive litigation and damaged corporate reputations that are not in the best interest of shareholders. In fact, a commitment to diversity in the workforce can lead to superior financial returns.

Vermont managers should:

• Vote FOR proposals calling for action on equal employment opportunity and anti-discrimination;
• Vote FOR legal and regulatory compliance and public reporting related to non-discrimination, affirmative action, workplace health and safety, environmental issues, and labor policies and practices that affect long-term corporate performance; and
• Vote FOR non-discrimination in salary, wages, and all benefits.

High-Performance Workplace

High-performance workplace practices emphasize employee training, participation, and feedback. The concept of a high-performance workplace has been endorsed by the US Department of Labor and refers to a workplace that is designed to provide workers with the information, skills, incentives, and responsibility to make decisions essential for innovation, quality improvement, and rapid response to changes in the marketplace. These standards embrace a "what's good for the worker is good for the company" philosophy. Studies have shown that improvement in human resources practices is associated with increases in total return to shareholders. High-performance workplace standards proposals can include linking compensation to social measures such as employee training, morale and safety, environmental performance, and workplace lawsuits.

• Vermont managers should generally support proposals that incorporate high-performance workplace standards.

Non-Discrimination in Retirement Benefits

A cash balance plan is a defined benefit plan that treats an earned retirement benefit as if it were a credit from a defined contribution plan, but which provides a stated benefit at the end of its term. Because employer contributions to these plans are credited evenly over the life of a plan and not based on a seniority formula, they may reduce pay-outs to long-term employees who are currently vested in plans.

Cash-balance pension conversions are undergoing congressional and federal agency scrutiny in the wake of high-profile EEOC complaints on age discrimination and employee anger at a number of companies. While significant policy reform is unlikely in the short term, business interests are worried enough that the *National Association of Manufacturers* and other pro-business lobbies are forming a coalition on Capitol Hill to preserve the essential features of the plans and to overturn a recent IRS ruling.

Driving the push behind conversions from traditional pension plans to cash-balance plans are the substantial savings that companies generate in the process. Critics point out that this savings is gained at the expense of the most senior employees. Resolutions call on corporate boards to establish a committee of outside directors to prepare a report to shareholders on the potential impact of pension-related proposals now being considered by national policymakers in reaction to the controversy spawned by the plans.

Vermont managers should:

• Generally support shareholder proposals calling for non-discrimination in retirement benefits; and
• Generally support shareholder proposals asking a company to give employees the option of electing to participate in either a cash balance plan or in a defined benefit plan.

MacBride Principles

These resolutions call for the adoption of the MacBride Principles for operations located in Northern Ireland. They request companies operating abroad to support the equal employment opportunity policies that apply in facilities they operate domestically. The principles were established to address the sectarian hiring problems between Protestants and Catholics in Northern Ireland. It is well documented that Northern Ireland's Catholic community faces much higher unemployment figures than the Protestant community. In response to this problem, the U.K. government instituted the New Fair Employment Act of 1989 (and subsequent amendments) to address the sectarian hiring problems.

Many companies believe that the Act adequately addresses the problems and that further action, including adoption of the MacBride Principles, only duplicates the efforts already underway. In evaluating a proposal to adopt the MacBride Principles, shareholders must decide whether the principles will cause companies to divest, and therefore worsen the unemployment problem, or whether the principles will promote equal hiring practices. Proponents believe that the Fair Employment Act does not sufficiently address the sectarian hiring problems. They argue that the MacBride Principles will stabilize the situation and promote further investment.

• Vermont managers should support the MacBride Principles for operations in Northern Ireland that request companies to abide by equal employment opportunity policies.

Contract Supplier Standards

These resolutions call for compliance with governmental mandates and corporate policies regarding nondiscrimination, affirmative action, work place safety and health, and other basic labor protections. Vermont generally supports proposals that:

• Seek publication of a "Worker Code of Conduct" to the company's foreign suppliers and licensees, requiring they satisfy all applicable labor standards and laws protecting employees' wages, benefits, working conditions, freedom of association, right to collectively bargain, and other rights;
• Request a report summarizing the company's current practices for enforcement of its Worker Code of Conduct;

• Establish independent monitoring programs in conjunction with local and respected religious and human rights groups to monitor supplier and licensee compliance with the Worker Code of Conduct;
• Create incentives to encourage suppliers to raise standards rather than terminate contracts;
• Implement policies for ongoing wage adjustments, ensuring adequate purchasing power and a sustainable living wage for employees of foreign suppliers and licensees;
• Request public disclosure of contract supplier reviews on a regular basis; and
• Adopt labor standards for foreign and domestic suppliers to ensure that the company will not do business with foreign suppliers that manufacture products for sale in the US using forced or child labor, or that fail to comply with applicable laws protecting employees' wages and working conditions.

Corporate Conduct, Human Rights, and Labor Codes

Investors, international human rights groups, and labor advocacy groups have long been making attempts to safeguard worker rights in the international marketplace. In instances where companies themselves operate factories in developing countries, for example, these advocates have asked that the companies adopt global corporate standards that guarantee sustainable wages and safe working conditions for their workers abroad. Companies that contract out portions of their manufacturing operations to foreign companies have been asked to ensure that the products they receive from those contractors have not been made using forced labor, child labor, or sweatshop labor. These companies are asked to adopt formal vendor standards that, among other things, include some sort of monitoring mechanism.

Vermont generally supports proposals that call for the adoption and/or enforcement of clear principles or codes of conduct relating to countries in which there are systematic violations of human rights. These conditions include the use of slave, child, or prison labor; undemocratically elected governments; widespread reports of abuse by human rights advocates; fervent pro-democracy protests; or economic sanctions and boycotts.

Globalization, relocation of production overseas, and widespread use of subcontractors and vendors often make it difficult to obtain a complete picture of a company's labor practices in global markets. Efforts that seek greater disclosure on a company's labor practices and that seek to establish minimum standards for a company's operations will be supported. In addition, requests for independent monitoring of overseas operations will be supported.

Many proposals refer to the seven core conventions, commonly referred to as the "Declaration on Fundamental Principles and Rights At Work," ratified by the International Labor Organization (ILO). The seven conventions fall under four broad categories: i) right to organize and bargain collectively; ii) non-discrimination in employment; iii) abolition of forced labor; and iv) end of child labor. Each of the 180 member nations of the ILO body is bound to respect and promote these rights to the best of its abilities.

Vermont managers should generally support proposals to adopt and implement the ILO principles and codes of conduct relating to company investment and/or operations in countries with patterns of human rights abuses or pertaining to geographic regions experiencing political turmoil (Northern Ireland, Columbia, Burma, former Soviet Union, and China);

Prepare Report on Operations in Sensitive Regions (i.e., Burma)

Since the early 1960s, Burma (also known as Myanmar) has been ruled by a military dictatorship that has been condemned for human rights abuses, including slave labor, torture, rape, and murder. Many companies have pulled out of Burma over the past decade due to the controversy surrounding involvement in the country. Oil companies continue be the largest investors in Burma, and therefore are the usual targets of shareholder proposals on this topic. However, proposals have also been filed at other companies, including financial companies, for their involvement in the country.

In 1998, the General Assembly of the State of Vermont enacted J.R.H. 157, expressing support for the efforts of the National League for Democracy in Burma and its leader Aung San Suu Kyi. Specifically: 1) The resolution requests that the Governor of the State of Vermont ensure that no state agency, department, or office of state government take any action that would undermine the efforts of the National League for Democracy to achieve its goals; 2) Sound investment policy requires consideration of the risks associated with investment of Vermont pension funds in companies that conduct business in countries with oppressive, nondemocratic governments. For purposes of this act, the portfolios of the Vermont retirement systems shall vote in favor of shareholder resolutions that raise concerns about doing business in Burma.

Vermont managers should:

• Generally support shareholder proposals to adopt labor standards in connection with involvement in Burma and other potentially sensitive geopolitical regions;
• Generally support shareholder proposals seeking reports on Burmese operations and activities, as well as reports on costs of continued involvement in the country; and
• Consider shareholder proposals to pull out of Burma and other countries on a CASE-BY-CASE basis considering factors such as overall cost, FDI exposure, level of disclosure to investors, and business focus of the company.

Environmental Reporting

Reports and enhanced disclosure addressing potential environmental liabilities and sustainable development are important to companies because they offer a formal structure for decision-making that helps management teams anticipate and address important risks and global trends that can have serious consequences for business and society. Shareholders may request general sustainability reports on a specific location (i.e., drilling in the Artic) or operation (i.e., nuclear facility), often requesting that the company detail the environmental, social, legal, and other risks and/or potential liabilities of the specific project in question. A number of companies have begun to report on sustainability issues using established standards in the marketplace. Such reporting focuses on corporate compliance and measurement regarding key economic, environmental, and social performance indicators. Many best practice companies release annual sustainability reports in conjunction with regular annual statement of operations.

Vermont managers should generally vote FOR shareholder proposals seeking greater disclosure on the company's environmental practices, and/or environmental risks and liabilities.

Global Warming/Greenhouse Gas Emissions

Scientists generally agree that gases released by chemical reactions including the burning of fossil fuels contribute to a "greenhouse effect" that traps the planet's heat leading to changing climate patterns, violent weather swings, melting glaciers, rising sea levels, and receding coastlines.

Vermont managers should generally vote FOR shareholder proposals calling for the reduction of greenhouse gas emissions under a reasonable timeline.

Invest in Clean/Renewable Energy

Filers of proposals on renewable energy ask companies to increase their investment in renewable energy sources and to work to develop products that rely more on renewable energy sources. Increased use of renewable energy will reduce the negative environmental impact of energy companies. In addition, as supplies of oil and coal exist in the earth in limited quantities, renewable energy sources represent a competitive, and some would even argue essential, long-term business strategy.

Vermont managers should generally support shareholder proposals seeking increased investment in renewable energy sources, taking into account whether the terms of the resolution are realistic or overly restrictive for management to pursue.

Report/Reduce Toxic Emissions and Assess Community Impact

Shareholder proposals asking companies to take steps to minimize their emissions of toxic chemicals or release of toxic waste into the environment can vary greatly. Some focus on reporting on the impact of these chemicals on the communities in which the company operates. Still others ask for a review of the company's efforts to minimize pollution.

Vermont managers should vote FOR shareholder proposals calling on the company to establish a plan reduce toxic emissions.

Adopt a Comprehensive Recycling Policy

A number of companies have received proposals to step up their recycling efforts, with the goal of reducing the company's negative impact on the environment and reducing costs over the long term.

Vermont managers should vote FOR shareholder proposals that ask companies to increase their recycling efforts or to adopt a formal recycling policy.

Label Products Containing Genetically Engineered Ingredients

Shareholders ask companies engaged in the development of genetically modified agricultural products to adopt a policy of not marketing or distributing such products until "long-term safety testing" demonstrates that they are not harmful to humans, animals, or the environment. Until further long-term testing demonstrates that these products are not harmful, companies in the restaurant and prepared foods industries are being asked to remove genetically altered ingredients from products they manufacture or sell, and label such products in the interim. Shareholders are asking supermarket companies to do the same for their own private label brands.

Vermont managers should vote FOR shareholder proposals to label products that contain genetically engineered products.

Tobacco-related Proposals

Shareholders file resolutions annually asking that companies with ties to the tobacco industry account for their marketing and distribution strategies, particularly as they impact smoking by young people.

Vermont managers should vote FOR shareholder proposals seeking to limit the sale of tobacco products to children.

Drug Pricing

Shareholder proponents, activists, and even some legislators have called upon drug companies to restrain pricing of prescription drugs. Against the backdrop of the AIDS crisis in Africa, shareholders have called on companies to address the issue of affordable drugs for the treatment of AIDS, as well as TB and Malaria.

Vermont managers should vote FOR shareholder proposals that call on companies to develop a policy to provide affordable HIV, AIDS, TB, and Malaria drugs in third-world nations.

Director Classification Chart

(Vermont uses the ISS director classification methodology)

Inside Director

- Employee of the company or its affiliates[1]
- Non-employee officer of the company if he/she is among the five most highly compensated individuals
- Listed as a Section 16 officer in the 10-K or proxy statement [2]
- Interim CEO
- Beneficial ownership of more than 50 percent of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a defined group, e.g., members of a family beneficially own less than 50 percent individually, but combined own more than 50 percent).

Affiliated Director

- Former executive of the company or its affiliates[2]
- Former interim CEO if the service was longer than one year, or if the service was between six months and a year and the compensation was high relative to that of the other directors (5x their pay) or in line with a CEO's compensation
- Former executive of an acquired firm
- Executive of a former parent or predecessor firm at the time the company was sold or split off from the parent/predecessor
- Executive, former executive, general, or limited partner of a joint venture or partnership with the company
- Relative of current employee of company or its affiliates
- Relative of former executive of company or its affiliates
- Currently provides (or a relative provides) professional services to the company or its affiliates or to its officers
- Employed by (or a relative is employed by) a significant customer or supplier[3]
- Has (or a relative has) any transactional relationship with the company or its affiliates, excluding investments in the company through a private placement [3]
- Has a contractual/guaranteed board seat and is party to a voting agreement to vote in line with management on proposals being brought to shareholders
- Has (or a relative has) an interlocking relationship as defined by the SEC involving members of the board of directors or its Compensation and Stock Option Committee[4]
- Founder of the company but not currently an employee
- Is (or a relative is) a trustee, director, or employee of a charitable or non-profit organization that receives grants or endowments from the company or its affiliates[3]
- Board attestation that an outside director is not independent or the outside director is considered non-independent under the relevant listing rules, except where such designations are not in conformity with ISS's independence/non-independence criteria.

Independent Director

- No connection to the company other than a board seat.

FOOTNOTES:

[1] "Affiliate" includes a subsidiary, sibling company, or parent company.
[2] "Executives" (officers subject to Section 16 of the Securities and Exchange Act of 1934) include the chief executive, operating, financial, legal, technology, and accounting officers of a company (including the president, treasurer, secretary, controller, any vice president in charge of a principal business unit, division, or function, and any other officer who performs policy-making functions). Corporate secretaries and general counsels not listed as officers and not employed by the company will be considered AO's.
[3]If the company makes or receives annual payments exceeding the greater of $200,000 or five percent of the recipient's gross revenues. (The recipient is the party receiving the financial proceeds from the transaction).
[4]Interlocks include: (a) executive officers serving as directors on each other's compensation or similar committees (or, in the absence of such a committee, on the board) or (b) executive officers sitting on each other's boards and at least one serves on the other's compensation or similar committee committees (or, in the absence of such a committee, on the board).